Passive Capital Management

Is It Different This Time? A Brief Historical Review of Market Returns

The Conclusions

1. Could the equity markets appreciate from current levels? Yes.

2. Could the equity markets deteriorate from current levels? Yes.

3. Is there any reliable methodology that would enable us to consistently predict the future? No.

4. Do we need to predict the future in order to have a successful investment experience? No, as long as we control those things that can be controlled, such as costs, tax efficiency, asset allocation, diversification and discipline.

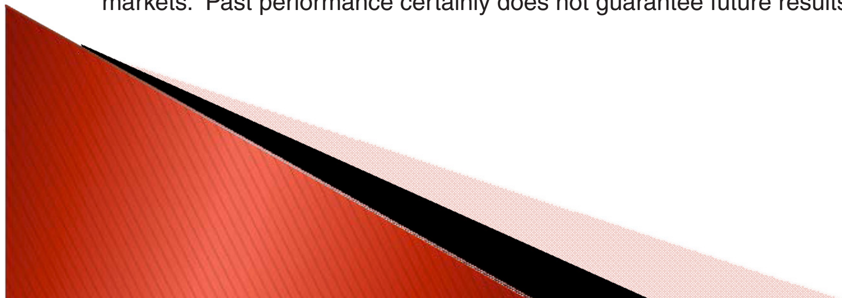
5. Bear markets must be endured so that investors can benefit from the returns that capital markets provide over time.

A Review of Historical Data

Given the significant deterioration in global equity markets over the past year, and especially during the 4th quarter of 2008, I thought it would be helpful to put the current data within some sort of historical context. While every bull and bear market has some unique characteristics, market cycles are an inherent aspect of investing and cycles must be endured if investors want to harness the returns that global capitalism provides over time. Because of the performance of equity markets over the past twelve months, it has become increasingly difficult to remember that markets can provide positive returns, albeit with the potential for significant volatility and risk. In my opinion, ***the current bear market is not an indication that markets have failed; rather, it is a reminder that capital market returns are a function of risk and are cyclical***. Capitalism is not perfect but it is more perfect than other economic systems and, over time, it allocates capital to companies and projects with relatively strong expected returns. It is also important to remember that even though risk may not be apparent all of the time, it exists all of the time. Some investors are now paying the price for risks that were not apparent only eighteen months ago; these risks include: leverage, illiquidity, lack of transparency, concentrated positions, skewed compensation of money managers, counter-party exposures, among others.

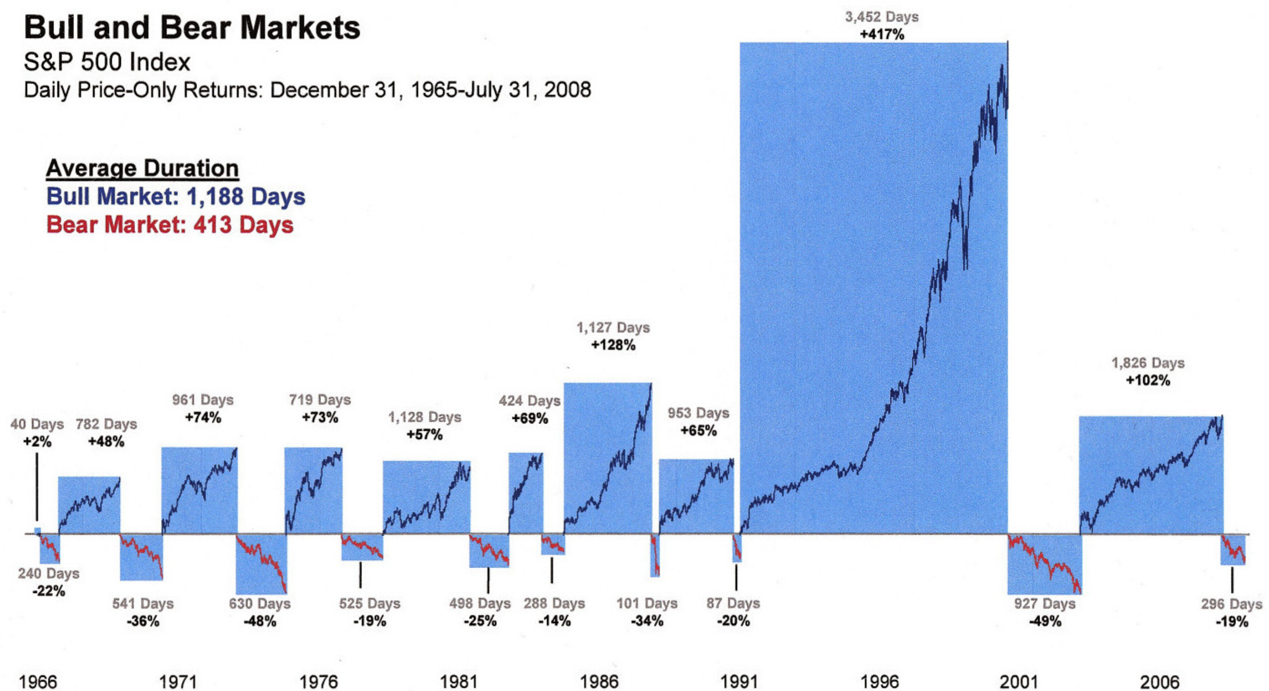
While I do not pretend to know when the equity markets will rebound in the future, we can look to the past for guidance on the duration and magnitude of previous bear markets. First, since 1965 the average duration of a bull market has been 40 months while the average duration of a bear market has been 14 months (see graph below); at the end of November 2008 the duration of the current bear market matched that of the historical average. Next, the S&P 500 Index of large domestic companies has dropped by approximately 52% from the peak in October 2007 to the current trough in late November 2008 while the Russell 2000 Index of small domestic companies has fallen by approximately 55%. As a point of reference, the S&P 500 dropped by over 40% during the bear markets of 2000-2002 and 1973-1974 and it dropped by over 60% from 1929-1932. In sum, the duration and magnitude of the current bear market are certainly within historical ranges, although the magnitude of this decline has not been a common occurrence. For those of us who want or need to maintain an investment portfolio, we must understand that we will come upon additional bear markets in the future and we must plan accordingly. We can plan accordingly by controlling those things that can be controlled, such as costs, tax efficiency, asset allocation, diversification (including high-quality bonds) and discipline.

The potential good news is that capital market returns have historically been quite strong following significant bear markets. Past performance certainly does not guarantee future results but we need to remember that capitalism



generally provides a return on capital commensurate with the systematic risk taken; if it did not do so then the system would break down because investors would stop risking their capital. *Since 1927 (through December 2008) the S&P 500 Index has provided compound annual returns of 9.6%* even though we've had a Great Depression, numerous wars, bouts of high inflation, energy independence issues, numerous terrorist attacks around the globe, excessive exuberance with technology stocks and now a significant decline in some areas of real estate and a restructuring of the landscape on Wall Street. The change has been constant. Because most of us do not have a time horizon of 80 years, let's look at returns over the past 20 years. Since 1988 the capital markets have also generated positive compound annual returns, for example: S&P 500 Index +8.5%, MSCI Emerging Markets Index +9.9%, Russell 2000 Index +7.8% and Five Year Treasury Notes +7.4%. Please keep in mind that even though these performance numbers are measured using the current bear market as the end point, the compound annual returns are still nicely positive. ***These returns have been available to every investor, although not every investor has accepted these returns primarily due to market-timing penalties and active- management underperformance.***

The turmoil in equity markets has been of concern to all investors and it has shined a bright light on many aspects of investing. While it is difficult to do at times of market extremes, whether in a bull market or bear market, we must always keep our emotions (fear and greed) at bay by adhering to a prudent, disciplined investment philosophy. It is important that we do not confuse poor absolute returns with a poor investment process; over short periods of time a great process might not lead to great absolute results. Nonetheless, there will come a time when the same process will generate above-average returns and we will be here to remind you that we need to stay disciplined and not let greed alter our long-term strategy.



The S&P data are provided by Standard & Poor's Index Services Group.
Bull and bear markets are defined in hindsight using cumulative daily returns. A bear market (1) begins with a negative daily return, (2) must achieve a cumulative return less than or equal to -15%, and (3) ends at the most negative cumulative return prior to achieving a positive cumulative return. All data points which are not considered part of a bear market are designated as a bull market.
Performance data represents past performance and does not predict future performance.

Data Source: Dimensional Fund Advisors' *Returns Program*

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